Ontario. Securities Commission.
[Committees] Committee on the problems of disclosure raised for investors by business combinations and private placements.

Summary of highlights of the Report.

REPORT OF THE COMMITTEE OF THE ONTARIO SECURITIES COMMISSION ON THE PROBLEMS OF DISCLOSURE RAISED FOR INVESTORS BY BUSINESS COMBINATIONS AND PRIVATE PLACEMENTS

(THE "MERGER STUDY")

SUMMARY HIGHLIGHTS OF THE REPORT

Background of the Study

Ontario's new disclosure legislation, The Securities Act, 1966, came fully into force on May 1st, 1967. The eighteen months which followed saw an accelerating picture of corporate business combinations including take-overs, private acquisitions and mergers. The new legislation, through its exemptions, facilitated this movement and gave rise to a changing pattern of corporate financing. Grave questions as to the adequacy of investor disclosure were raised particularly in financial reporting. The Honourable H. Leslie Rowntree, Q.C., then Minister of Financial and Commercial Affairs, in a letter dated April 14th, 1969, to the then Commission Chairman, H. E. Langford, Q.C. requested the Commission to undertake a study of the area.

The Committee

On April 17th, 1969, the Commission convened and appointed three of its members, Vice-Chairman H.S. Bray, Q.C. and Commissioners D.S. Beatty and John Willis to undertake the study. Mr. Bray chaired the committee.

Terms of Reference

These were as follows:

> "In the light of present practices and conditions, to review and report upon existing legislation, regulation and policy relating to consolidations, amalgamations, mergers, re-organizations, take-overs, private placements and exempt purchases, and related subjects, and generally to recommend what, if any, changes in the law appear desirable."

The Object of Disclosure Legislation

The theoretical standard which is aimed for is equality of information for all investors in the market place. This was the major advance made through the Kimber Committee recommendations and the present legislation. This report examines the present legislation in the light of this concept, weighs its strengths and its deficiencies.

The Committee concluded that the evolution commenced in The Securities Act, 1966, should be completed. Current information should be available to investors at all times. This, in turn, provides the basis for an integrated and consistent system which will cater for the needs of investors when business combinations occur, when securities are made available to exempt purchasers or through private placements and through the existing exemptions.

The Need of Investors for Facts - The "Need to Know" Concept

The requirement for prospectus disclosure is triggered in the present legislation when, in the language of the basic definition, there is a "primary distribution to the public". If there are no sales to the "public" then a prospectus and

the other kinds of continuing disclosure are not required. Who then are the "public" the legislation seeks to protect? The subject proved so fundamental to the study that Chapter III is devoted to it. In summary, the Committee concludes that the word "public" serves only to confuse. It does not assist in the context of disclosure legislation.

The Committee concluded that the legislation, without declaring its purpose, provides a scheme of exceptions to the prospectus requirement where, for one reason or another, it was felt the investor did not require a prospectus standard of disclosure. The legislators appeared to require a prospectus when they concluded the investor needed the protection afforded by the information contained in that document and the prophlatic-procedure which precedes its acceptance. This is what is shortly styled the "need to know" test.

The Committee concluded that the word "public" should be removed from the definition of "distribution" and, for greater certainty, all "distribution" should be prohibited unless there is adequate investor protection. The exceptions to that general prohibition should be specific, based upon the "need to know" concept, with a residual discretion such as is presently found in section 59 of the Act, in the Commission to provide for flexibility in specific cases.

Continuing and Timely Disclosure

The evolution of timely disclosure policies to meet the problems of the market place coupled with the standards of continuing statutory disclosure now required through legislation

and regulation lead to the conclusion that we are presently a very short step from an integrated continuing disclosure system. This must provide for a standard of disclosure equivalent to that found in the present prospectus requirements on a current basis. This flowed from the consideration of the problems of adequate disclosure raised in business combinations. If adequate disclosure concerning all material facts about the issuer's affairs is available to the market place, the necessity for and the tendency to restrictions on resale, where securities are issued through private placements, to exempt purchasers, and as the result of business acquisitions, would disappear.

The present narrative prospectus, while providing much clearer disclosure than the previous form, still tends to be a confusing and excessively detailed document for most people. The facts currently disclosed in a prospectus must continue to be available, however, to the analysts and advisers, as well as to sophisticated investors, so they may have adequate facts upon which to offer opinions to clients. What has sometimes been called a short form of prospectus, which the Committee call an "offering circular", would substitute for the present prospectus after the initial distribution has taken place as the document required to be delivered to all investors. The back-up prospectus standard disclosure material would be available and delivered only upon request.

Continuing Disclosure - Recommendations

The Committee recommends that a full integrated continuing disclosure system be established as follows:

(1) "Distribution" be prohibited unless a disclosure document has been submitted and accepted by the Commission for filing.

(2) Initial distribution of an issuer's securities would, as presently, be through a prospectus. This prospectus would also be the cornerstone for continuing disclosure of all material facts relating to the issuer's affairs. Upon the acceptance of the prospectus, the issuer would assume the obligations and become a "reporting company".

(3) A reporting company would file regular quarterly reporting statements, including unaudited financial statements, and, where a material change occurs, would file within 10 days of the happening of the event. (It must now amend its prospectus during the course of a distribution, an amendment to its basic statement.)

This "timely amendment" would disclose such matters as private placements and the purpose of those placements and, in the case of business acquisitions, the details of the acquisitions. The material changes which occur during the year would be summarized in a yearly disclosure filing, which would also contain the audited financial statements. The continuing disclosure documents would be filed with the Commission but not reviewed by it prior to their ruling.

(4) The dissemination of the "continuing disclosure" information must be facilitated by the Commission.

(5) Distribution of additional securities into the market place by an issuer, which is a reporting company, or through an underwriter would require an "offering circular". This circular would be reviewed and accepted for filing by the Commission staff in conjunction with the material on the public disclosure file for both adequacy and compliance. The offering circular would substitute for the prospectus as the document required to be delivered to a prospective purchaser, with a right in that investor to obtain a copy of the more sophisticated and detailed facts in the public file.

(6) Generally speaking, where the issue of securities is permitted a reporting company under an exemption, the issuer will be required to file a "timely amendment". Twenty-eight days must then elapse from the time the amendment is filed to permit the adequate dissemination of the facts set out in that amendment. After the expiry of the 28-day period, provided no special selling effort is made, no further restrictions on resale will be imposed.

(7) As to potential abuse or avoidance of the filing of an offering circular, it is not recommended that any substantial change be made in the present definition of "underwriter". Proceedings may be instituted where the facts demonstrate that there was an underwriting.

(8) The result should be to encourage "non-reporting companies" to become "reporting companies" to enable their security holders who acquired securities through an exemption to re-sell them. Provision must be made for the filing of a corner-stone prospectus even where the issuer is not then contemplating a distribution. In addition, the securities of non-reporting companies will not be included in the new Investment Dealers' Association unlisted trading data.

(9) The alternative to filing a prospectus would be to apply to the Commission for an exemption under an amended section 59.

(10) The result should not only be a higher standard of fairness in the market place but, because there is an equality of information, a greater liquidity flowing from the proposed relaxation of restrictions on resale.

Control Persons

The Committee recommends that the restrictions on the resale by control persons be relaxed where the issuer is a reporting company, providing 28 days have elapsed since the fact of the control position was first disclosed, the sales are made without any special selling efforts, and the control person reports the fact of the sales within three days.

Exempt Purchaser and Private Placements

It is recommended that exempt purchasers should be subject to the same requirements as purchasers through private placements as regards the filing of reports and purchasing with investment intent. It is not recommended that they be subject to the minimum subscription rule however. The reporting company will be required

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to file a timely amendment, but will not in the amendment be required to name the purchaser. The purchasers, under both classes of exemption, will file a report of the purchase, including the declaration of investment intent, and will report subsequent resales. These reports will be for the use of the Commission in maintaining surveillance over the use being made of the exemptions.

Business Combinations

In an integrated disclosure system, subject to the questions raised in financial disclosure, business combinations provide no real problem. The definitions have been examined and recommendations made to clarify them. The persons receiving securities of a reporting company, as the result of selling or exchanging assets for securities or as the result of some other legal corporate restructuring, will be subject to the 28 day restriction generally applicable following the filing of the required timely amendment or other disclosure documents.

Take-Over Bids

This is but a special way of achieving a form of business combination. The Committee has concluded that the disclosure required by the present legislation has worked effectively. It is not recommended that the take-over bid circular be reviewed by the Commission staff before it can be used. The necessity for this has not been demonstrated. However, since it is the equivalent of prospectus disclosure and must be delivered to the offeree, it is recommended that the material be certified in the same fashion

as a prospectus, and the liabilities of the signatories under the Act be the same as for a prospectus.

As to the question as to whether the offeror in a cash offer should be permitted to continue to conceal his identify, it is recommended that where the offer is for less than all of the securities, he should disclose his identity.

It was concluded that the acquisition of large blocks of securities in the market place was significant and should be reported. Taking 20% as the basis, an insider is required to report within three days of his holdings reaching 20% of the voting stock and must report each plateau of 5% attained thereafter. For greater certainty, it is recommended that "ownership" be determined as of the day when the insider or his agent contracts to purchase the shares regardless of when he takes delivery.

Where the take-over bidder is purchasing in the market place, as well as through the tender offer, his obligation to report his purchases in the market place will remain. In order that there will be certainty as to the tender offer, it is recommended that he not be permitted to reduce the number of shares tendered for by the number purchased in the market.

Where the tender offer is for all the shares it is recommended that the offeror be required to commence taking up the securities tendered or terminate his offer and return the securities after 35 days, the same as for a partial offer.

Where the terms of the offer are changed it is recommended that those who have already tendered their shares be permitted a further seven days withdrawal period running from the mailing of the amended offer. In addition, it is recommended that "market out" clauses or similar escape clauses be prohibited. The only permissible qualification would be that the offeror could stipulate the number of securities he must receive before he is bound by the offer. The rule, in the case of a partial offer, regarding pro rata acceptance of the securities would remain the same.

Accounting for Business Acquisitions

The two methods of accounting for business acquisitions, the "pooling of interest" and "purchase" methods, were considered. It was concluded that the subject should be left to the Canadian Institute of Chartered Accountants to formulate rules. The recent study "Business Combinations in the 60's : A Canadian Profile" (Joint Study) suggests the urgency, when it recommends the study be undertaken and completed by the end of 1970.

Reporting companies will make business acquisitions the subject of a timely amendment. The Committee recommends the adoption of the "Acquisition Equation" designed by the Joint Study. This, supplemented by additional facts, such as an earnings history for two years for pooled companies, will provide adequate investor disclosure. The recommendations do not involve fundamental questions of accounting principles.

The Committee also recommends the disclosure of both basic earning per share and fully diluted earnings per share in accordance with the principles recently enunciated by the Canadian Institute of Chartered Accountants. Pending the result of their further studies, it is recommended that diversified companies should be required to report gross revenues by classes or lines of business, the grouping being the responsibility of management. Companies having gross sales and revenues exceeding $25,000,000 should report those classes or lines of business contributing 10% or more to their consolidated gross revenue. For those having $25,000,000 or less the test would be 15%.